

Memorandum

To : Honorable Carole Migden, Chairwoman
Honorable Claude Parrish, Vice-Chairman
Honorable Bill Leonard
Honorable John Chiang
Honorable Steve Westley, Controller

Date: June 11, 2003

From : Jean Ogrod 
Acting Chief Counsel, Legal Department

Subject: **Petition for Amendment of Property Tax Rule 462.500, *Change in Ownership of Real Property Acquired to Replace Property Taken By Governmental Action or Eminent Domain Proceedings* - From: Terry L. Polley, Esq. of Ajalat, Polley & Ayoob**

Chief Counsel Matters - Wednesday, June 25, 2003

Attached for the Board's consideration is Legal Departments staff's recommendation on the above Petition for Amendment of Property Tax Rule 462.500. Staff has reviewed the petition and recommends that the Board defer publication of the requested amendments subject to a more thorough analysis by the Property Tax Committee. If you have any questions on this matter or would like additional information, please contact Assistant Chief Counsel Kristine Cazadd at (916) 323-7713 or Senior Tax Counsel Paul Steinberg at (916) 322-1057.

JO:pas:lg

Rules/462.5/03/01PasCoverLetter

Precedent/Emdomain/03/03PasCoverLetter

Attachment(s)


cc: Mr. Timothy Boyer, MIC:73
Ms. Kristine Cazadd, MIC:82
Mr. David Gau, MIC:63
Mr. Dean Kinnee, MIC:64
Ms. Mickie Stuckey, MIC:62
Mr. Harold Hale, MIC:61
Mr. Paul Steinberg, MIC:82
Ms. Jennifer Willis, MIC:70

bc:	Ms. Marcy Jo Mandel	(Controller's Office)
	Mr. Steve Kamp	MIC:71
	Ms. Carole Ruwart	MIC:71
	Mr. Tim Treichelt	MIC:78
	Mr. Neil Shah	MIC:77
	Mr. John Thiella	MIC:72

Memorandum

To: Ms. Jean Ogrod
Acting Chief Counsel

Date: June 11, 2003

From: Ms. Kristine Cazadd 
Assistant Chief Counsel

Subject: **Petition for Amendment of Property Tax Rule 462.500, *Change in Ownership of Real Property Acquired to Replace Property Taken By Governmental Action or Eminent Domain Proceedings* - Terry L. Polley, Esq. of Ajalat, Polley & Ayoob**

Chief Counsel Matters - Wednesday, June 25, 2003

On March 28, 2003, Ms. Kristine Cazadd, Assistant Chief Counsel, Property Taxes Division, received the attached petition pursuant to Government Code section 11340.6 from Terry L. Polley, Esq., of Ajalat, Polley & Ayoob to amend Property Tax Rule 462.500. The Rule interprets and implements Article XIII A, section 2(d) and Revenue and Taxation Code section 68. It provides that a taxpayer whose property is acquired by eminent domain or other governmental action may transfer the adjusted base year value of that property to a comparable replacement property (Attachment 1). Mr. Polley requests that the Board amend subsection (c) of Rule 462.500, which sets forth the standards and criteria for comparability of replacement properties, to incorporate by reference the definition of "like kind" as provided in the Internal Revenue Code and Treasury Regulations. The suggested amendment specifies that replacement property would be deemed to satisfy the requirements of similarity in function and utility if the property would be deemed to be "like kind" as defined by United States Treasury Regulation section 1.1031(a)-1.

Mr. Polley asserts that the intent of article XIII A, subdivision (2)(d), and section 68 were to allow a taxpayer to transfer a base year value from a taken property to a replacement property as long as the taxpayer reinvests the condemnation proceeds. He contends that the Rule as currently written unnecessarily complicates this process. Rule 462.500, subsection (c), requires that a "qualified replacement property" must be similar to the property taken in size, function, and utility. He states that the inability of anyone to objectively define "similar use" has created a great deal of unnecessary confusion.

According to Mr. Polley, amendment of subsection (c) of Rule 462.500 to reference the Internal Revenue Code and the body of law that has been developed to determine whether property qualifies as "like kind" would greatly simplify the process of determining whether replacement property has a similar use for purposes of applying section 68.

The language suggested by Mr. Polley is a reference to "like kind" property within the meaning of Treasury Regulation section 1.1031(a)-1. Attachment 2 is a copy of the proposed language including overstrikes and underlines; Attachment 3 is a copy of the proposed language in a final version; Attachment 4 is a copy of subsection (c) of the existing Rule. A possible effect of adoption of such a proposal could be a broader definition of comparability, allowing more replacement properties acquired after eminent domain to receive the exclusion.

Pursuant to Government Code section 11340.7, subdivision (a), the Board has 30 days from receipt to deny the Petition in whole or in part, indicating the reasons why, or to schedule the Petition for public hearing. Mr. Polley has agreed to extend the time limit by 90 days in order to give staff sufficient time to review his request. Accordingly, this matter is scheduled for consideration by the Board at its meeting on Wednesday, June 25, 2003, on the Chief Counsel Matters Agenda.

Staff has reviewed Mr. Polley's request and recommends that the Board defer initiation of the requested rulemaking process in order to consult with assessors, other agencies and persons affected by the regulation through the interested parties process. Staff will then prepare an Issue Paper analyzing the rule request and the interested parties' comments, and recommend appropriate action to the Property Taxes Committee at a future date determined by the Chairman of the Committee.

Alternatively, the Board could at this time deny the petition in its entirety, or initiate the rulemaking process and order publication of the notice required by Government Code Section 11346.5 and schedule a public hearing on the proposed amendment at the conclusion of the 45-day public comment period.

Attachments

KEC:pas;lg
Rules/462.500/03/01Pas.doc
Precedent/Emdomain/03/03Pas.doc

cc: Mr. Lou Ambrose
Mr. Paul Steinberg

LAW OFFICES

AJALAT, POLLEY & AYOOB

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*PROFESSIONAL CORPORATION

March 28, 2003

Ms. Kristine Cazadd
State Board of Equalization
450 "N" Street, MIC:82
Sacramento, CA 95814

Received

APR 02 2003

Legal Department
State Board of Equalization
Property Taxes

Re: Petition for Rule Change

Dear Ms. Cazadd:

As you are aware, we have been wrestling with the application of Rule 462.500 for the last nine months or so. I believe that Regulation is overly complicated and not necessary to implement the underlying policy considerations of CA Const. Article XIII A (2)(d) and Section 68. CA Const. Article XIII A (2)(d) and Section 68 were designed to avoid further penalizing the property owner (increased property taxes) after his or her property has been taken in a condemnation proceeding. The unstated assumption is that as long as the taxpayer reinvests the condemnation proceeds, he or she should be able to transfer the base year of the old property to the new property. Rule 462.500 unnecessarily complicates this process.

In order to have "qualifying replacement property," a new property must be similar in size, function and utility. The regulation defines size in terms of value, function in terms of government restrictions and utility in terms of similar use. The inability of anyone to define objectively "similar use" has created a great deal of unnecessary confusion.

We believe that reference to the income tax code and the whole body of law developed thereunder would greatly simplify this process. The Internal Revenue Code has a couple of sections that are instructive. First, Internal Revenue Code Section 1031 provides for the nonrecognition of gain or loss where there is an exchange of "like kind" property under certain circumstances. In the case of real estate, "like kind" is interpreted very broadly. For example, Section 1.1031-1 of the Treasury Regulations provides, in pertinent part:

"(b) Definition of 'like kind.' As used in section 1031(a), the words 'like kind' have reference to the nature or character of the property and not to its grade or quality. . . . The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. . . .

“(c) Examples of exchanges of property of a ‘like kind.’ No gain or loss is recognized if . . . (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate”

For reasons peculiar to income taxes, Section 1031 applies only if both properties in the exchange are either held for productive use in a trade or business or held for investment. Thus, for example, a primary or secondary residence, recreational property or any property held primarily for sale does not qualify for nonrecognition under Section 1031. This requirement is not included in Revenue and Taxation Code Section 68 and should not be added to Rule 462.500.

Second, Internal Revenue Code Section 1033 provides for the nonrecognition of gain or loss where there is an involuntary conversion of property under certain circumstances. There are a number of types of transactions that constitute involuntary conversions, including the destruction and theft of property. However, Section 1033(g) contains a special rule for involuntary conversions that result from condemnation. Section 1.1033(g)-1(a) of the Treasury Regulations, which interprets this special rule, provides, in part, as follows:

“In such cases, for purposes of applying section 1033, the replacement of such property with property of like kind to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted. For principles in determining whether the replacement property is property of like kind, see paragraph (b) of § 1.1031(a)-1.”

The regulation refers back to Section 1031. As noted above, Section 1031 provides for a broad definition of like kind property in the context of real property.

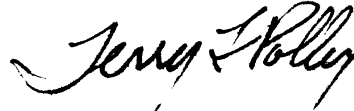
We believe that Rule 462.500 can and should be greatly simplified by replacing nearly all of the existing requirements in subsection (c) (“Comparability”), which are not included in CA Const. Article XIII A (2)(d) or Section 68, with a reference to “like kind” property within the meaning of Internal Revenue Code Section 1031 and the Treasury Regulations thereunder. One exception that should be retained in subsection (c) is the limitation of 120% of the award or purchase price paid for the replaced property.

Ms. Kristine Cazadd
March 28, 2003
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I would be happy to discuss this in greater detail if you think that would be helpful.

Thank you very much in advance for your consideration.

Very truly yours,

A handwritten signature in black ink, appearing to read "Terry L. Polley". The signature is fluid and cursive, with a large initial "T" and a stylized "P".

Terry L. Polley

TLP/sh

PROPOSED CHANGES TO
PROPERTY TAX RULE 462.500

RULE 462.500. CHANGE IN OWNERSHIP OF REAL PROPERTY OF REAL PROPERTY
ACQUIRED TO REPLACE PROPERTY TAKEN BY GOVERNMENTAL
ACTION OR EMINENT DOMAIN PROCEEDINGS.

(c) COMPARABILITY. Replacement property, acquired by a person displaced under circumstances enumerated in (a), shall be deemed comparable to the replaced property if it is similar in size, utility, and function.

~~———— (1) ——— Property is similar in function if the replacement property is subject to similar governmental restrictions, such as zoning.~~

~~———— (2) ——— Both the size and utility~~(1) Size of property are interrelated and associated withrelates to value. Property is similar in size and utility only to the extent thatif the replacement property is, or is intended to be, used in the same manner as the property taken (i.e., single family residential and duplex, multi family residential other than duplexes, commercial, industrial, agricultural, vacant, etc.) and its full cash value does not exceed 120 percent of the award or purchase price paid for the replaced property.

~~———— (A) ——— A replacement property or any portion thereof used or intended to be used for a purpose substantially different than the use made of the replaced property, shall to the extent of the dissimilar use be considered not similar in utility.~~

~~———— (B) ——— A replacement property or portion thereof which satisfies the use requirement but~~property. A replacement property, or portion thereof, that has a full cash value which exceeds 120 percent of the award or purchase price shall, be considered, to the extent of the excess, not similar in utility and size.

~~———— (3) ——— To the extent that replacement property, or any portion thereof, is not similar in function, size and utility, the property, or portion thereof, shall be considered to have undergone a change in ownership.~~

(2) Property is similar in function if the replacement property is subject to similar governmental restrictions, such as zoning.

(3) Property is similar in utility if the replacement property is, or is intended to be, used in the same manner as the property taken.

(4) For purposes of paragraphs (2) and (3), any replacement property that would be deemed to be of a “like kind” to the property taken pursuant to Section 1.1031(a)-1 of the United States Treasury Regulations shall be deemed to have similar function and utility.

____ (5) ____ To the extent that replacement property, or any portion thereof, is not similar in function, size and utility, the property, or portion thereof, shall be considered to have undergone a change in ownership.

EXAMPLE: A home is replaced by a combination dwelling and commercial property. Relief is applicable to only the dwelling portion of the replacement property; the commercial portion shall be considered as having changed ownership.

EXAMPLE: A combination dwelling and commercial property is replaced with a home. Only the dwelling portion of the property taken shall be considered in determining the comparability and the amount of relief. The right to relief on the commercial portion of the property taken is waived unless comparable replacement commercial property is acquired after the date of displacement and a timely request is made for assessment relief.

EXAMPLE: A combination dwelling and commercial property is replaced with a home, and later the displaced person also acquires a separate comparable replacement commercial property. Pro-rata relief shall be granted on both the replacement home and commercial property to the extent provided in subdivision (b) (1).

PROPOSED CHANGES TO
PROPERTY TAX

**RULE 462.500. CHANGE IN OWNERSHIP OF REAL PROPERTY OF REAL PROPERTY
ACQUIRED TO REPLACE PROPERTY TAKEN BY GOVERNMENTAL
ACTION OR EMINENT DOMAIN PROCEEDINGS.**

(c) **COMPARABILITY.** Replacement property, acquired by a person displaced under circumstances enumerated in (a), shall be deemed comparable to the replaced property if it is similar in size, utility, and function.

(1) Size of property relates to value. Property is similar in size if its full cash value does not exceed 120 percent of the award or purchase price paid for the replaced property. A replacement property, or portion thereof, that has a full cash value which exceeds 120 percent of the award or purchase price shall, be considered, to the extent of the excess, not similar in size.

(2) Property is similar in function if the replacement property is subject to similar governmental restrictions, such as zoning.

(3) Property is similar in utility if the replacement property is, or is intended to be, used in the same manner as the property taken.

(4) For purposes of paragraphs (2) and (3), any replacement property that would be deemed to be of a "like kind" to the property taken pursuant to Section 1.1031(a)-1 of the United States Treasury Regulations shall be deemed to have similar function and utility.

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§ 462.500. Change in Ownership of Real Property Acquired to Replace Property Taken by Governmental Action or Eminent Domain Proceedings

(c) Comparability. Replacement property, acquired by a person displaced under circumstances enumerated in (a), shall be deemed comparable to the replaced property if it is similar in size, utility, and function.

(1) Property is similar in function if the replacement property is subject to similar governmental restrictions, such as zoning.

(2) Both the size and utility of property are interrelated and associated with value. Property is similar in size and utility only to the extent that the replacement property is, or is intended to be, used in the same manner as the property taken (i.e., single-family residential and duplex, multi-family residential other than duplexes, commercial, industrial, agricultural, vacant, etc.) and its full cash value does not exceed 120 percent of the award or purchase price paid for the replaced property.

(A) A replacement property or any portion thereof used or intended to be used for a purpose substantially different than the use made of the replaced property, shall to the extent of the dissimilar use be considered not similar in utility.

(B) A replacement property or portion thereof which satisfies the use requirement but has a full cash value which exceeds 120 percent of the award or purchase price shall be considered, to the extent of the excess, not similar in utility and size.

(3) To the extent that replacement property, or any portion thereof, is not similar in function, size and utility, the property, or portion thereof, shall be considered to have undergone a change in ownership.

EXAMPLE: A home is replaced by a combination dwelling and commercial property. Relief is applicable to only the dwelling portion of the replacement property; the commercial portion shall be considered as having changed ownership.

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EXAMPLE: A combination dwelling and commercial property is replaced with a home, and later the displaced person also acquires a separate comparable replacement commercial property. Pro rata relief shall be granted on both the replacement home and commercial property to the extent provided in subdivision (b)(1).

REGULATION HISTORY

TYPE OF REGULATION: Property Tax

REGULATION: 462.500

TITLE: Change in Ownership of Real Property Acquired to Replace
Property Taken by Governmental Action or Eminent Domain
Proceedings

PREPARATION: Kristine Cazadd/Paul Steinberg

LEGAL CONTACT: Kristine Cazadd/Paul Steinberg

Amendments to Rule 462.500, *Change in Ownership of Real Property Acquired to Replace Property Taken by Government Action or Eminent Domain Proceedings*, have been proposed to the incorporate the definition of "like kind" property as provided by the Internal Revenue Code and federal regulations as a definition of comparable property to replace property acquired through eminent domain or other governmental action.

REGULATION HISTORY

June 25, 2003: Placed on Chief Counsel Matters for Board approval to amend rule.

April 2, 2003: Petition received to amend rule submitted by Terry L. Polley, Esq., Ajalat, Polley & Ayoob.